

CREDIT OPINION

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Seattle (City of) Sewer Enterprise, WA

Update to credit analysis

Summary

[The City of Seattle, Washington's sewer enterprise](#) (Aa1 stable) benefits from a large and wealthy service area that includes the City of Seattle, as well as neighboring communities. Although the coronavirus pandemic had significantly negative economic effects on the region, the financial impacts of the coronavirus pandemic on the sewer enterprise were modest, with a relatively small increase in delinquencies that were easily managed. The strong credit profile is supported by healthy financial operations characterized by sound debt service coverage and solid liquidity levels bolstered by access to the city's shared liquidity pool. Regulatory compliance and capital planning are well-managed by a strong management staff. The utility has an excellent rate management history, raising rates as necessary to maintain sound coverage levels in light of sizeable capital needs.

Credit strengths

- » Stable, established customer base and service area
- » Demonstrated willingness to increase utility rates
- » Access to citywide cash pool for liquidity purposes
- » Solid coverage levels

Credit challenges

- » Significant capital needs related to combined sewer overflow projects
- » High customer utility bills relative to regional and national peers

Rating outlook

The rating outlook is stable. The utility has sufficient cash and ample access to additional liquidity to manage any near-term spikes in delinquencies should economic conditions worsen, though increases in vaccination rates and broader economic reopening makes that less likely. Affordability will be a longer-term challenge for the city as water consumption continues to decline and rates increase to pay for system operations, maintenance and improvements.

Factors that could lead to an upgrade

- » Material increase in debt service coverage levels
- » Reduction in future capital needs related to environmental compliance issues

Factors that could lead to a downgrade

- » Deterioration in pledged revenue and coverage
- » Substantial increase in debt levels to address environmental compliance issues

Key indicators

Exhibit 1

Seattle Drainage & Wastewater					
System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	26 years				
System Size - O&M (in \$000s)	\$346,298				
Service Area Wealth: MFI % of US median	162.9%				
Legal Provisions					
Rate Covenant (x)	1.25				
Debt Service Reserve Requirement	DSRF funded at lesser of standard 3-prong test (Aa)				
Management					
Rate Management	Aa				
Regulatory Compliance and Capital Planning	Aa				
Financial Strength					
	2016	2017	2018	2019	2020
Operating Revenue (\$000)	\$375,041	\$400,284	\$419,876	\$454,382	\$460,295
System Size - O&M (\$000)	\$288,658	\$310,186	\$317,601	\$330,092	\$349,925
Net Revenues (\$000)	\$92,530	\$100,209	\$113,271	\$141,196	\$123,354
Net Funded Debt (\$000)	\$689,273	\$867,354	\$843,409	\$814,620	\$798,085
Annual Debt Service (\$000)	\$49,045	\$51,944	\$52,370	\$53,252	\$47,360
Annual Debt Service Coverage (x)	1.9x	2.0x	2.2x	2.7x	2.7x
Cash on Hand	153 days	194 days	212 days	255 days	228 days
Debt to Operating Revenues (x)	1.8x	2.2x	2.0x	1.8x	1.7x

Financial figures reflect non-cash adjustments for pension and OPEB.

Source: Seattle Public Utility and Moody's Investors Service

Profile

The combined drainage and wastewater system serves the [City of Seattle](#) (Aaa stable) and its rapidly growing urban population of roughly 760,000. The drainage system conveys stormwater runoff through various modes, including storm drains, a combined stormwater and wastewater system and a ditch, culvert and creek system. The wastewater system is responsible for the collection and transmission of wastewater to regional treatment facilities that are operated by [King County](#) (Aaa stable).

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Detailed credit considerations

Service area and system characteristics: key utility service provider to Seattle

The utility system benefits from a strong service area economy that is beginning to rebound as vaccination rates increase and businesses begin to return to pre-pandemic levels of operations. The city is the commercial and tourist hub of the Puget Sound region and the economic center of the [State of Washington](#) (Aaa stable). Software development and aircraft manufacturing are key components of the local economy, and the area serves as the headquarters or major operating base to some of the world's most well-known international corporations, including [Amazon](#) (A2 positive), [Boeing](#) (Baa2 negative), [Microsoft](#) (Aaa stable), and [Starbucks](#) (Baa1 negative). Amazon and other technology firms have performed well during the pandemic by providing direct or enabling technologies that can capitalize on the broad "shelter in place" orders taking place across the country. Both business and leisure travel to the region remain significantly depressed, and general economic activity remains below pre-pandemic levels, though conditions have improved significantly. Preliminary unemployment data for February show the city rate declined to 5.5%, which is much higher than the 2.1% in November 2019 prior to the pandemic but well below the April 2020 peak of 16.2%.

Income measures for the city are a credit strength. The city has one of the highest educational attainment rates in the country, along with some of the strongest income levels among large urban areas in the United States, with median family income at 162.9% of the US.

The drainage system conveys stormwater runoff through various modes, including storm drains, a combined stormwater and wastewater system and a ditch, culvert and creek system. The drainage system's 221,000 accounts are principally residential (70%), though revenue generation is more evenly split with commercial, as drainage fees are based on a property's estimated impact on the drainage system. Single family and duplex properties under 10,000 square feet pay an annual flat fee based on the size of the property, while all other properties are charged based on the percent of impervious surface area and lot size. The largest customer of the drainage system is the city (7.1% of revenue in 2020), with the Top 10 customers generating 18.1% of revenue in 2020, similar to figures from prior years.

The wastewater system is responsible for the collection and transmission of wastewater to regional treatment facilities that are operated by King County. Like the drainage system, the wastewater system's accounts are also principally residential (88.8% of 174,963), but unlike the drainage system wastewater revenue is more heavily driven by commercial accounts (65.2%). Notably, the coronavirus pandemic resulted in a decline in commercial utilization by 13% but an increase in residential revenue by 4%, and a re-ordering of top customers. The largest customer of the wastewater system in 2020 was the Seattle Housing Authority (2.1% of revenue), followed by the University of Washington (1.8%), with the Top 10 customers generating 8.7% of revenue; the University historically has been the largest customer, with greater hotel representation in the top ten.

Unlike the drainage system, the wastewater system revenue is subject to some monthly variability. Residential customers are charged based on actual water consumption from November through April and the lesser of actual consumption or average winter water consumption from May through October. Commercial customers are charged based on actual water consumption throughout the year unless they install wastewater submeters. The city anticipates conservation efforts and slower population growth will result in declining demand of approximately -0.1% annually over the next several decades.

Debt service coverage and liquidity: coverage is strong and expected to remain healthy; liquidity bolstered by access to city's consolidated cash pool

Debt service coverage is strong, despite increasing annual debt service for bond issuances to finance CSO projects, flooding and sewer pipe rehabilitation. Although operating revenue was down 4% from forecast, with the variance likely attributable to some combination of the coronavirus and hydrological conditions, the utility's trend of revenue growth continued. Top-line revenue for 2020 reached \$460.3 million, up from \$454.4 million in 2019. By ordinance, city utility taxes are remitted to the city after the payment of debt service, though in practice are remitted monthly. Net revenue available for debt service in 2020 was \$123.4 million, sufficient to provide 2.7 times debt service. Debt service coverage is expected to remain fairly flat in the near-term over the next several years as rates increase to meet growing operating and debt service expenses.

LIQUIDITY

Seattle's utilities have historically maintained low levels of cash on their own balance sheets. This is mitigated by their ability to access liquidity in the city's \$2.5 billion consolidated cash pool. Short-term liquidity (up to 90 days) can be accessed with approval of the city's finance director. For long-term liquidity, the enterprise must receive approval of the city council. The loans bear interest at the yield of the investment pool, which is low given the short-term investment nature. This cash management approach has been tested and demonstrated successful, with the city's electric enterprise borrowing in excess of \$100 million from the cash pool during the 2001 power crisis. The combined drainage and wastewater system generates healthy operating cash flow. The enterprise ended 2020 with \$218.7 million of cash in working capital, or 228 days of cash on hand, a level Moody's views as strong. The forward projection for the enterprise shows significantly declining cash balances through 2023, though the city has historically outperformed similar projections by considerable margins. The impact of the coronavirus pandemic to the enterprise's financial liquidity has been extremely modest, as delinquencies of 90+ days increased by less than 1% of annual sales.

Debt and legal covenants: debt to increase with CSO program; legal protections satisfactory

The drainage and wastewater enterprise is modestly leveraged, with \$742 million in revenue bonds outstanding, not including \$192 million in WIFIA loans that have not yet been drawn upon. Inclusive of the full WIFIA loan amounts, the enterprise is only modestly leveraged 2.3x operating revenue. The utility's capital program through 2026 calls for \$1.3 billion in projects, including \$450 million for CSO projects. The city expects to pay for these projects using \$448 million of operating cash, \$149 million in contributions and grants (mostly from King County) and \$736 million in debt, including the WIFIA loan. The increase in leverage is material but appears manageable given currently strong margins and expected rate-driven revenue increases.

DEBT STRUCTURE

The combined drainage and wastewater debt is structured with declining debt service to allow for layering of additional bond issuances in the future. The city will not begin making principal payments for the WIFIA loans until 2026.

DEBT-RELATED DERIVATIVES

The drainage and wastewater system has no debt-related derivatives.

PENSIONS AND OPEB

Pensions and other post-employment benefits are not a material driver for the drainage and wastewater utility. According to our approach to analyzing pensions, the utility had an adjusted net pension liability at the end of 2020 of \$223.8 million, based on a discount rate of 3.22% (vs an assumed 7.25%). This is a very manageable 0.49 times operating revenue. Contributions have historically been very modestly below its "tread water" mark; that is, it is contributing slightly less than necessary to keep pension liabilities from growing, given plan assumptions.

Reported OPEB liabilities were just \$3.1 million at the end of 2020. The city satisfies its OPEB expenses on a pay-as-you-go basis, and the utility's share is limited to the implicit subsidy associated with retiree healthcare and is minimal.

ESG considerations

Environmental

Environmental considerations are an important consideration in the sewer enterprise's overall credit quality. The city has medium risk exposure to extreme rainfall, water stress and sea level rise, according to Moody's affiliate Four Twenty-Seven. Because some of the city's sewage and stormwater flows move through a single set of pipes, extreme rainfall events have led to significant sewer overflows into local waterways that can create significant health and environmental risks.

In 2013, a consent decree was entered into between the Department of Justice, on behalf of the EPA and DOE, and the city related to the city's combined sewer overflow (CSO) reduction program and management of its wastewater system. The Final Plan to Protect Seattle's Waterways was approved by the EPA and Ecology in August 2015 in accordance with the city's consent decree requirements. The plan requires the construction of a large combined sewage storage facility, several smaller storage and sewer system improvement projects and three projects to remove pollutants from stormwater. Under the consent decree, the construction of all CSO control measures is to be completed no later than the end of 2030.

Social

Social considerations are an important factor in the sewer enterprise's overall credit quality. Resident income measures are among the highest in the nation for a large urban area. The coronavirus pandemic is also a factor under our ESG framework given its impact on public health and safety. While coronavirus is having a significant impact on the city's governmental finances, the public utilities have demonstrated significant financial stability.

However, the average monthly sewer bill in Seattle is high relative to many of its regional peers. This is similarly the case with the city's water and solid waste utilities, the result of which is a high composite utility rate for users and potentially constrained flexibility for individual utility rates. By 2023, the utility's strategic plan projects the typical monthly single-family residence to have a combined utility bill (excluding electricity) of \$248, while a typical monthly apartment residential bill will reach \$142.

To help with affordability, the city offers a discount program for qualifying low-income customers. In addition to direct customer assistance, the utility is looking at other steps to help bend the "cost curve" down over time, including making improvements to capital planning and delivery, expansion of partnership opportunities and improving regulatory alignment. The city has adopted legislation to assist customers affected by the coronavirus by enabling the utilities to waive interest on delinquent utility bills during the state of emergency. Although this may impact the utility's cash flow, as noted previously the utility has access to the city's large liquidity pool. Over time, the city's ability to manage affordability while satisfying regulatory and service-level needs will continue to be an important credit factor that Moody's will monitor moving forward.

Governance

Seattle's Public Utility governance is a credit strength. The city's management team has demonstrated its willingness and ability to generate additional revenue. Rates are set by city council and are not subject to state oversight. Under the public utility's current strategic plan (adopted by the city council in 2017 with a draft update currently in review), combined utility rates (including water, sewer, drainage and solid waste) are expected to increase by an average of 5.2% annually through 2023, with sewer rates increasing by an average of 5.8% and drainage increasing an average of 8.7%. For the wastewater system, city ordinance allows the utility to pass through county wastewater treatment charges based on adopted wholesale rates and projected bill consumption.

The structure of Seattle's utility billing is a credit strength for the wastewater and drainage systems. Wastewater customers are billed on a combined utility statement, with partial payments applied first to solid waste, then wastewater and lastly to water. The city has the authority to shut off water to enforce collections, limiting delinquent or unpaid bills. The drainage fees are billed by King County on behalf of the city on the county's property tax statement. A lien is applied to properties for non-payment of drainage bills. The largest operating expense for the drainage and wastewater systems is the wastewater treatment contract with King County. As noted above, the wastewater system can pass on to its customers the county's charges for capital and other operating costs of sewage treatment and disposal.

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